State Tax Haven Legislation: A Misguided Approach to a Global Issue

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Council On State Taxation: COST is a nonprofit trade association consisting of nearly 600 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities

State Tax Research Institute: The State Tax Research Institute (STRI) is a 501(c)(3) organization established in 2014 to provide educational programs and conduct research designed to enhance public dialogue relating to state and local tax policy. STRI is affiliated with the Council On State Taxation (COST).

Topics Covered

- Existing "Tax Haven" Provisions
- Arguments by Proponents
- Arguments Against Tax Haven Legislation:
  - Tax Haven Lists are Arbitrary and Unmanageable
  - International Profit Shifting Is Not Eroding the State Corporate Tax Base
  - Tax Haven Legislation Represents a Return to the Discarded Mandatory Worldwide Reporting Method
  - Tax Haven Legislation is Contrary to the State's Economic Development Efforts
  - Tax Haven Legislation Will be Challenged as Unconstitutional
  - The Tax Haven Approach Is Out of Sync With the Global Approach to Base Erosion and Profit Shifting (BEPS)
  - States Have Other Options
- Where to go Next?

Existing "Tax Haven" Provisions

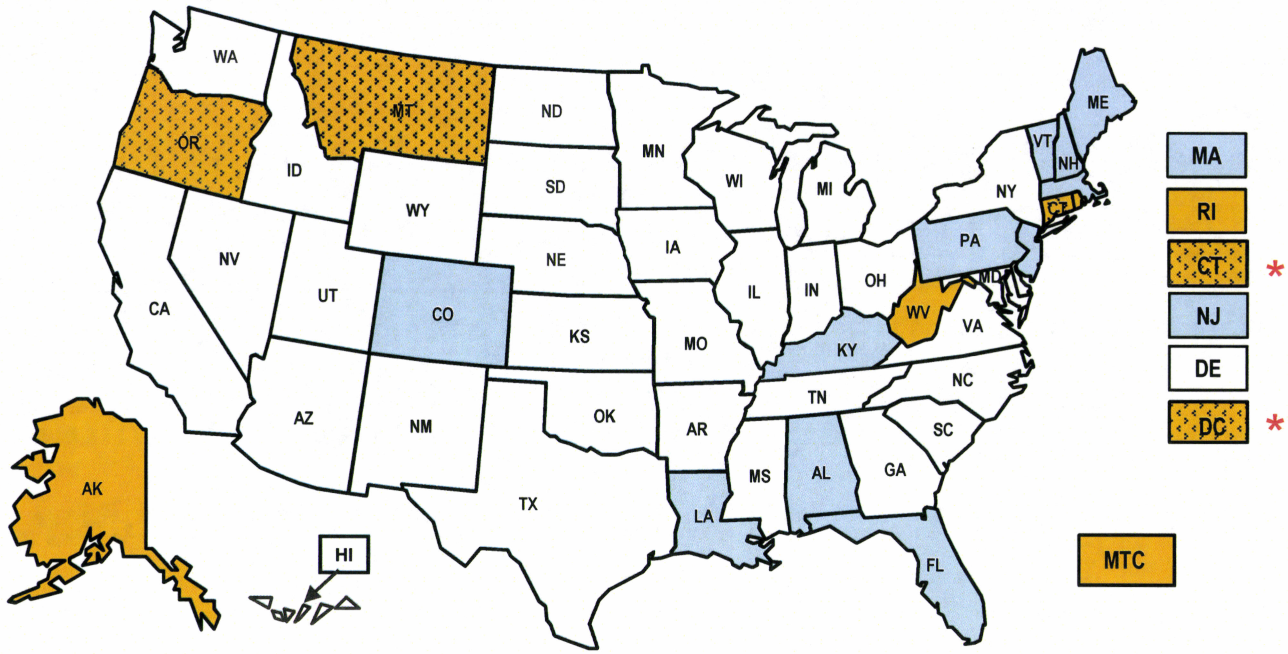
- Six states (Alaska, Connecticut, Montana, Oregon, Rhode Island, and West Virginia) plus D.C. currently have some form of a "tax haven" provision that seeks to include certain foreign entities in a state's unitary combined return.
- Only two states (Montana and Oregon) define a "tax haven" on the basis of a list of foreign jurisdictions (commonly referred to as a "blacklist" approach). The other five jurisdictions employ a facts and circumstances test modeled after the MTC's "tax haven" criteria definition.
- While 12 states considered tax haven legislation in 2015, only one (Connecticut) enacted such legislation.

“Tax Haven” State Enactment Status, with 2015 Proposals

Enacted Tax Haven Provisions

Tax Haven “Blacklist” Included or Required in Enacted Legislation

2015 Proposals- Not Enacted



* DC and Connecticut have subsequently repealed or removed the “blacklist” requirement in favor of “indicia” of tax havens.

Arguments by Proponents of Tax Haven Legislation

- Tax Haven legislation effectively plugs a gaping hole in the state tax base caused by “profit shifting” to international tax havens.
- Tax Haven legislation is an effective solution to counteract tax avoidance by U.S. multinationals.
- Failure to act at the federal level justifies state “self help”
- Income should be aligned with value creation and substance.
- (Big) Business does not pay its “fair share” of state and local taxes.
- Small business disadvantaged, unable to use tax haven “loopholes.”

Tax Haven Lists are Arbitrary and Unmanageable

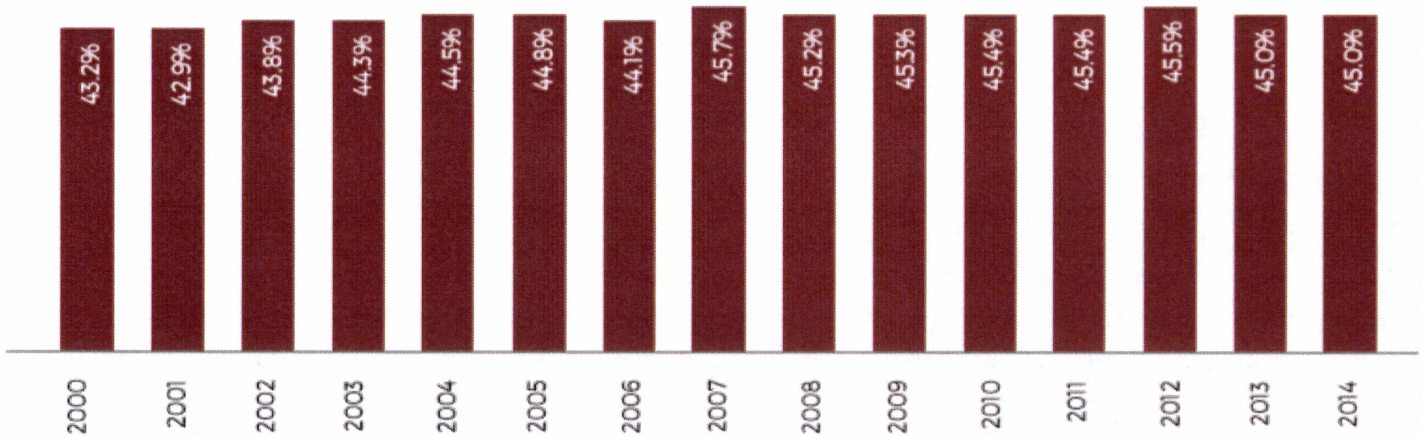
- The Tax Haven blacklist is based on an outdated OECD list developed for transparency and information sharing purposes, not for tax base expansion.
- The OECD disbanded its list once all of the countries complied with its requirements.
- The Multistate Tax Commission, West Virginia, the District of Columbia, and Connecticut all initially favored a tax haven blacklist, but then subsequently abandoned this approach in favor of the "criteria approach."
- Left to their own designs, states generally lack in-house expertise in foreign affairs, international tax, transfer pricing rules, permanent establishment rules and international treaties to assist them in evaluating which countries should be included or removed from the blacklist.
- The faulty premise of tax haven legislation: profits booked to these foreign nations are *per se* tax evasion and should be included in the state income tax base.

International Profit Shifting Is Not Eroding the State Corporate Tax Base

- There is no clear evidence that profit shifting to international tax havens is eroding the state corporate tax base.
- According to the analysis relied on by the proponents of state tax haven legislation, the peak of corporate base erosion and profit shifting has been since 2000 – with 85 percent of the alleged rise in annual tax revenue loss occurring during those years.
  - During that period, the share of state and local taxes paid by businesses actually rose from 42.6 percent in FY2000 to 45 percent in FY2014.
  - And, the state corporate income tax (and other business activity taxes) as a share of overall state and local taxes paid by business has also been relatively stable over the last 15 years, ebbing and flowing primarily with the cycles of the U.S. economy.
- The U.S.PIRG estimates of tax revenue losses attributable to tax havens are wildly inflated – four to ten times higher than OECD estimates.

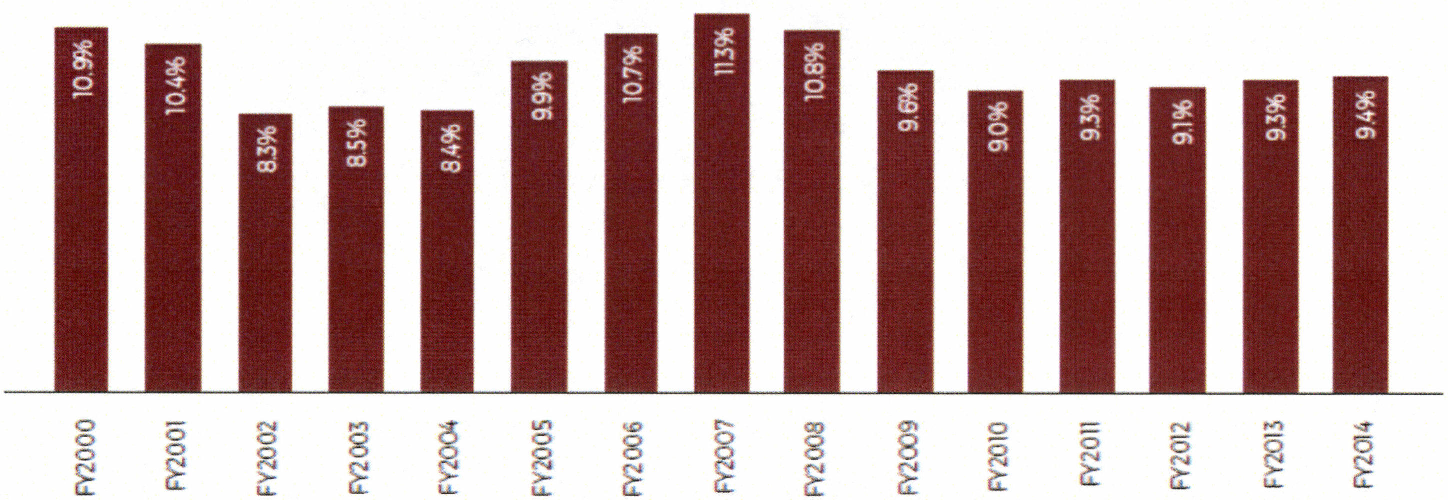
International Profit Shifting Is Not Eroding the State Corporate Tax Base

The business share of state and local taxes is actually increasing

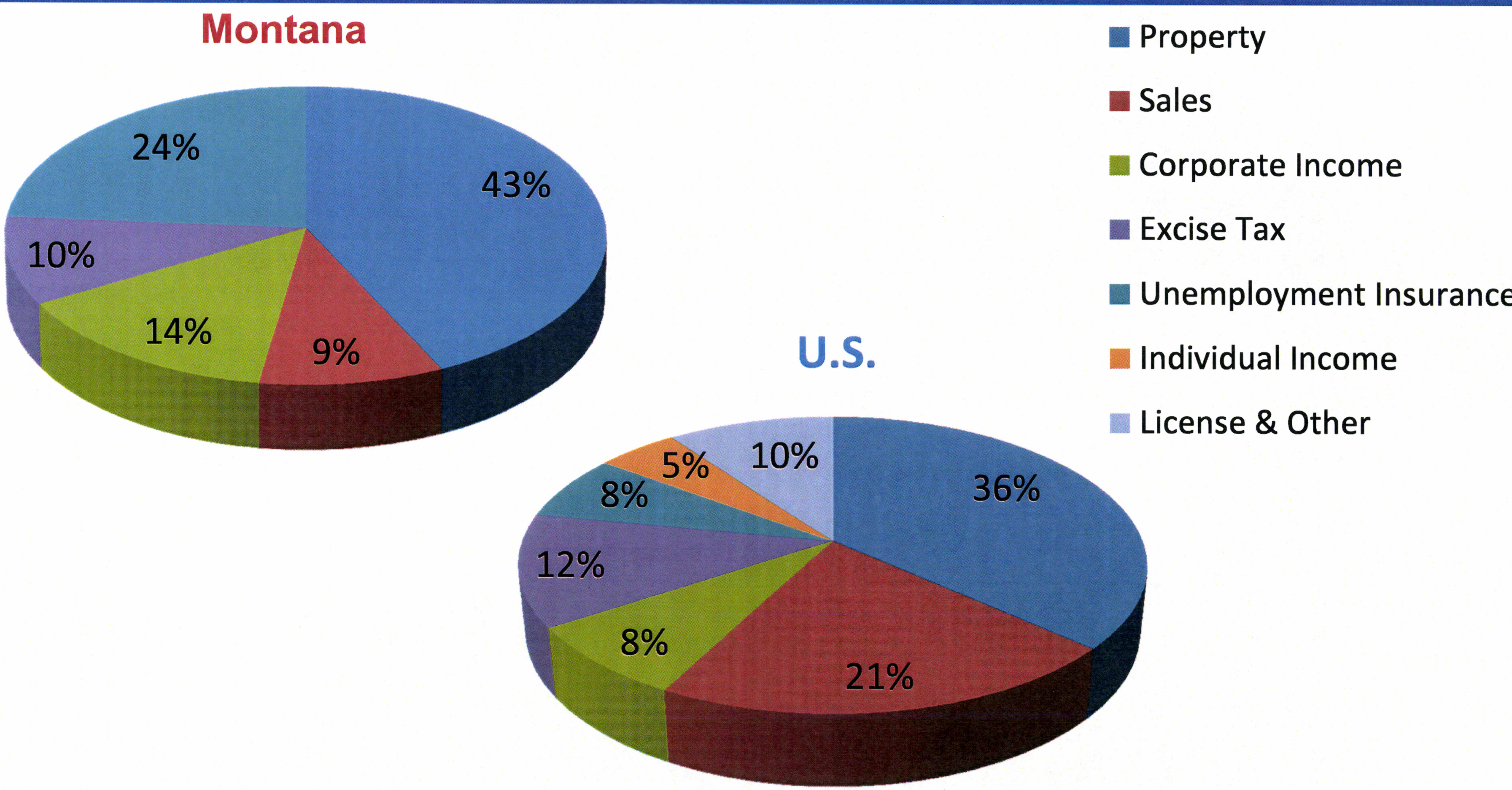


Share of State and Local Taxes Paid by Businesses

State and Local CIT and Other Business Activity Taxes As Share of State and Local Business Taxes



FY 2014 Total State & Local Business Taxes – U.S. and Montana



COST/EY Study, *Total state and local business taxes: State-by-state estimates for FY 2014*, October 2015

State Tax Haven Legislation Represents a Return to the Discarded Worldwide Reporting Method

- As of 1984, approximately 12 states imposed mandatory worldwide reporting.
- After threatened retaliation from foreign governments and pressure from the U.S. government, all of these states abandoned mandatory worldwide reporting in favor of water's-edge reporting.
- The adoption of tax haven legislation breaks this 30-year consensus of water's edge reporting.
- State tax haven legislation operates in the same manner as mandatory worldwide combination, albeit with the income from some but not all foreign countries included in the state's tax base.

State Tax Haven Legislation is Contrary to the State's Economic Development Efforts

- Montana has targeted international investment as part of its economic development efforts.
  - Governor Bullock has made trips abroad to encourage such efforts
- Foreign direct investment is a major contributor to the U.S. economy:
  - 5.8 million American job, which is more than 5 percent of all private sector employment
    - —18 percent of U.S. Manufacturing Workforce
    - —33 percent higher wages than economy wide average
  - 21 percent of U.S. exports
  - 15 percent of U.S. research and development expenditures
  - $200 billion in annual property, plant and equipment purchases
- Montana is ranked last in the nation for foreign direct investment employment.
  - 7,100 FDI Jobs in MT
  - Tax haven policies targeting Switzerland or the Netherlands could directly impact the 500 Montanans who work for U.S. subsidiaries of companies based in either of these countries.

Tax Haven Legislation Will Be Challenged as Unconstitutional

- While the United States Supreme Court upheld the constitutionality of worldwide combination in the *Container/Barclays* cases, tax haven legislation raises different issues.
  - The results may be different with state tax haven statutes that make selective determinations about the adequacy of foreign nations' laws and arbitrarily designate certain nations for punitive treatment.
- State tax haven legislation will almost certainly face legal challenges under the Foreign Commerce Clause and Foreign Affairs Powers Doctrine.
- With the enactment of tax haven legislation, states are meddling in foreign affairs and international relations – areas the Constitution entrusts solely to the Federal Government.

The Tax Haven Approach Is Out of Sync With the Global Approach to BEPS

- The Organization for Economic Co-operation and Development (OECD) recently completed a massive international tax reform project aimed at addressing Base Erosion and Profit Shifting (BEPS).
- G20 and OECD governments representing 90 percent of the world's population have endorsed the OECD's recommended solutions.
- Absent from the several thousand pages of OECD reports and the OECD recommended solutions is any support for singling out "bad actor" countries to be placed on a blacklist of so-called "tax haven" nations.
- The OECD solutions target outdated tax rules applied to particular transactions and structures that do not adequately reflect where the income is earned.

States Have Other Options

- States have other tools to tax effectively connected foreign source income:
  - —Alternative Apportionment
  - —Commissioner's Discretionary Authority (state-IRC § 482 authority)
  - —Statutory related party expense add-back requirements
  - —Economic Presence Nexus
  - —Business Purpose & Economic Substance

Where to go Next?

- States that have enacted tax haven legislation are generally small states or states with low populations.
  - Montana is out of step with 96 percent of the U.S. population.
- The MTC and other states have moved away from "blacklist" approach.
- Montana's prior legislative proposals, which would pull in larger foreign nations, would likely impact Montana's economy negatively and could potentially result in retaliation by U.S. trading partners against the State.
- A return to worldwide reporting is contrary to good tax policy.